

## **OTHER ARTICLES**

### **The Long and Bumpy Road to Glass-Steagall Reform**

#### ***A Historical and Evolutionary Analysis of Banking Legislation***

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**ABSTRACT.** This paper focuses on understanding the role of interest groups and markets in influencing regulatory change. To that end, it first identifies the interest groups surrounding the creation of legislation that separated commercial and investment banking in the 1930s and then identifies the interest groups involved in the more recent attempts to repeal the separation. Careful attention is also given to developments in the private market that affect the legislative process. This then becomes the case study for understanding how interest groups and market developments are able to influence regulatory policy. This particular case study finds that existing orthodox economic and political science literature gives too much credit to interest groups and not enough credit to private market developments when analyzing policy development and reform.

[T]he Banking Act of 1933 (passed last week by accident because a Presidential blunder kept Congress in session four days longer than expected) requires private bankers to give up either their banking or their securities business. (*Time*, June 26, 1933, p. 45)

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## I

**Introduction**

COMMERCIAL BANKERS PLAY A VITAL ROLE in the well-being of an economy. They function as intermediaries that bring together savers and borrowers to allow for economic expansion and the realization of entrepreneurial goals. A well-functioning banking system is, thus, a necessary condition to a well-functioning economy. During the Great Depression neither banking nor the macro-economy functioned very well. As a consequence, a comprehensive legislative package was passed to regulate and reform banking. An important part of this legislative reform was the Glass-Steagall provisions of the Banking Act of 1933. These provisions essentially separated commercial and investment banking. Investment banks were no longer able to accept deposits and commercial banks were no longer able to invest in, underwrite, or distribute corporate securities.

Sixty-six years later Congress passed a bill to dismantle Glass-Steagall. This legislative development came after years of congressional debate. While Congress was busy in debate, the courts and regulators were slowly removing barriers by allowing commercial banks into investment banking and insurance sales. At the same time, the financial market and technological developments made Glass-Steagall increasingly inappropriate if commercial banks were to remain a viable member of the financial sector. Market innovations coupled with relaxed regulation meant that by the end of the millennium the only barrier remaining between commercial and investment banks and insurance sales was Glass-Steagall.

The purpose of this paper is to determine what role interest groups and the market have played in the life of Glass-Steagall. Existing regulatory literature from economics and political science tends to emphasize interest groups and under emphasize, or even neglect, the role that markets play in the creation or reform of regulation and legislation. A careful look at both the creation and dismantling of Glass-Steagall suggests that market developments actually play an important role in the timing and nature of regulation and reform. Further, it becomes clear that regulation disrupts the market process, forever altering the regulated industry and its participants.

## II

**Relevant Literature**

TWO CLASSIFICATIONS of existing literature may be helpful in the analysis of the role played by markets and interest groups in regulatory change. On the one hand, it is important to understand what current literature says about gaining access to changing legislation, particularly regulation. Thus, we initially review literature on the political process. However, it is equally important to understand the theory of economic regulation, which says something about how regulation is created and also changed.

*A. Political Process Literature*

Existing literature within the fields of political science and economics offers explanations for how groups or individuals gain access to the policy process. The traditional view in political science envisions a stable relationship between three concerned groups: an executive agency, a congressional committee, and organized interest groups. The collective relationship between these three, known as an iron triangle, is long-standing and allows the interest groups access for influencing both policy and its implementation (Lowi and Ginsberg 1998). Heclo (1978), who finds the notion of iron triangles to be incomplete, has challenged this traditional view, arguing that the closed and controlled nature of iron triangles no longer reflects the political reality of policy making. Rather, the growth and specialization in government creates diverging interests and hence more interest groups, which greatly complicates the iron triangle. Heclo envisions issue networks as a means of gaining access to policy decisions. These issue networks are groups of individuals with shared knowledge regarding a policy or problem. Like interest groups, issue networks seek to influence and have a voice on issues in which they are informed. Compared to iron triangles, issue networks are less formal and, at the same time, more focused on a particular problem or agenda. Because neither of these perspectives affords an important role to the developments of the private market, neither is found to be completely compelling in understanding the Glass-Steagall reforms considered in this paper.

Economists also offer perspectives on access to policy making. According to Becker (1983), individuals belong to groups, defined in this instance by industry, who attempt to improve their well-being by using political power and pressure to achieve certain goals. It is the competition between the interest groups that determine the political outcome, be it regulation, tax policy, or subsidy policy. In their model of interest group behavior surrounding branch-banking legislation, Abrams and Settle (1993) also begin with Becker's framework.

### *B. Economic Theory of Regulation*

McChesney (1997) outlines the evolution of economic thought on the theory of regulation. Through 1970, the prevalent theories understood regulation to be necessary in order to correct perceived failures in the market. In 1971, George Stigler introduced a different way to look at regulation by modeling it through the process of exchange. If there were an effective demand for regulation as well as a supply, the outcome would be regulation. From this perspective, it is understood that firms may desire and benefit from regulation. Such benefits are known as rents or political rents (McChesney 1997). These benefits, however, often come at a high cost, particularly since there must be an incentive for those supplying the regulation. These costs, in addition to market distortions, may include votes, campaign contributions, and other lobbying costs paid by the beneficiaries of the regulation.

In Stigler's (1971) model, firms were hypothesized to benefit from regulation at the expense of consumers. More recently, this model has been expanded to recognize situations in which subgroups within a particular industry may search for infra-marginal rents through regulation at the expense of other subgroups in the industry. For example, small bankers may seek regulation that keeps all commercial banks isolated from investment banking because that will ensure them more of a competitive position against the large commercial banks. However, economic theory also suggests that the subgroup that may lose, for example, the large bankers, will find it worthwhile to also seek political rents. Thus, regulation may be viewed as an exchange process in which many groups have an incentive to lobby the political process for rents.

*C. Contributions to the Literature*

The political process and regulation literature complement each other from the perspective that the process literature examines *how* interested groups gain access to the political process while the regulation literature explains *why* they would be interested in doing so. This analysis borrows some of the theory from existing literature but is also critical of it for two reasons. First, this literature focuses primarily on the role of interested groups or subgroups and says little about the role markets often play in the legislative process. Yet, regulation or deregulation is frequently a response to market developments. Second, unlike Becker (1983) and Abrams and Settle (1993), who envision interest groups as maximizers able to achieve some political equilibrium, this paper argues that there is no equilibrium but, rather, an evolutionary process of adjustment.<sup>1</sup> In other words, as industries and the economy continue to evolve, the interests of the group continue to change and adapt. New knowledge, new products, new ways of doing business, and new competition continue to change the industry so that the interests of the group evolve with the dynamics around them. From this perspective, one shared with Hayek (1937), it is neither desirable nor possible to reach an equilibrium. As this paper considers the long and often bumpy road of Glass-Steagall reform, it becomes clear that equilibrium has not been reached and, indeed, that more bumps may lie on the road ahead.

## III

**History of the Relationship Between Commercial  
and Investment Banking**

PRIVATE BANKS (unincorporated) generally conducted two types of business: investment and/or general banking. During the first decade of the 20th century the majority of private bankers involved in securities catered to large institutions and businesses only. These large institutions, such as J. P. Morgan, engaged in underwriting, buying, and distributing new issues and usually did not accept deposits from the general public, only from corporate clients, friends, and employees (Carosso 1970:89). Consequently, the financial needs of the smaller retail companies and other small enterprises seeking to go public were

unmet. This provided an opportunity for another small group of private banking and brokerage houses to become underwriters. Those accepting this opportunity were private bankers such as Goldman, Sachs and Co. and Lehman Brothers.

An informal code of ethics regarding competition among and between private bankers ruled securities dealings, including mutual respect for their respective client bases. More formally, often original purchase or underwriting contracts included a clause requiring the corporation to offer all additional securities over a specified period through the originator's firm. In this way competition was kept to a minimum between large private banking and investment institutions.

At the turn of the century, state commercial banks began deviating significantly from their orthodox role as lenders of short-term industrial credit by becoming important suppliers of credit in the securities field. State commercial banks became involved in securities partly through direct purchases of securities for the banks' own asset portfolios and partly through the granting of call loans. Moreover, their bank credit was primarily secured by stocks and bonds as collateral. Though it is not known exactly how much commercial bank credit was allocated to investment purposes during this time, it has been estimated that one-half of their credit in 1909 went for loans or purchases of securities (Krooss and Blyn 1971). State commercial banks usually conducted their securities business through bond departments established to handle the bank's own investments.

Following the Civil War there had been an explosion of new securities issued to finance railroads leading to the western United States and the expansion in public utility fields. Many state chartered banks had taken advantage of this opportunity by furthering their involvement in securities underwriting. Historically, national banks were barred from underwriting or dealing in corporate stocks by the absence of any legal power to do so in the National Bank Act (Nichols 1984). Thus, while the boundaries for national banks' involvement with corporate securities were not expressly stated, the National Bank Act was interpreted and implemented such that corporate security dealings were banned. Eventually, several steps were taken to explicitly keep national banks from underwriting corporate stocks. By a 1902 ruling of the Comptroller of the Currency, national banks had no

legal authority to underwrite corporate securities (Litan 1987). In addition, several court hearings during the turn of the century prohibited national banks from engaging in commercial securities activity. Beginning with the First National Bank of New York in 1908, national banks responded to these restrictions by creating holding companies under state chartered affiliates that could then underwrite corporate securities and engage in securities dealings (Nichols 1984).

State banks took advantage of profitable securities operations and by 1929, 356 state banks were engaging in securities business, either directly or through affiliates, as compared to 205 in 1922 (Litan 1987). In an attempt to level the playing field, national banks were allowed to underwrite securities approved by the Comptroller of the Currency under the McFadden Act in 1927. In 1926 approximately 1,100 national banks were active in securities dealings via state chartered affiliates. By 1930 the number rose to 1,900. In dollar terms, national banks' securities dealings amounted to \$1 billion in mid 1928 and \$4.5 billion in 1930 (Krooss and Blyn 1971:155). Thus the McFadden Act significantly increased the role of the national banks within the field of securities activities.

The post-war period gave additional energy to securities activity as stocks and bonds became extremely profitable investments. The war brought with it the widespread sale of Liberty Bonds. These Liberty Bonds were distributed primarily through commercial banks and created a crowd of investors in men and women who had previously saved through deposit institutions. The new wave of investors often turned to their bankers for investment advice, increasing the bank's exposure to the security-buying public and further sparking the commercial banker's interest in investment banking (Preston and Finlay 1930a). Additionally, business's investment strategy turned away from bank borrowing and toward open-market commercial paper and securities to finance investment projects. These changes in business activity encouraged the financial intermediaries' involvement in securities dealings. However, the infamous stock market crash of 1929 and its subsequent financial panic caused profitability to plummet, thereby reversing the tide of rising securities activity.

The quality of securities offered to the public also changed dramatically in the late 1920s as a result of the changing nature of securities

dealings. Anderson (1949) argues that banks had a positive record in investment dealings through 1927 for two reasons. First, most banks and investment affiliates did not put their names upon issues so neither the banks' nor the investment affiliates' reputation were at risk. Second, the investment affiliates were able to keep organizational costs low because they had no retail sales organization. With the establishment of high-pressure sales organizations and selling issues bearing the banks' names, there was immense pressure to provide securities, regardless of the quality. According to Anderson, this development was an important factor in the deterioration of the quality of the new securities offered for public purchase.

In addition to falling profitability and quality within the securities field, another development contributed to the demise and eventual regulation of securities dealings: the Gray-Pecora investigation. Under the instruction of President Herbert Hoover, the investigation began in March of 1932. Initially, the Senate Banking and Currency Committee or one of its subcommittees was directed to make a thorough and complete investigation of buying and selling practices as well as borrowing and lending of securities upon the stock exchange. The findings of the subcommittee's effort (fraud and deception by investment firms) damaged the reputation of the investment bankers.

In January of 1933 Ferdinand Pecora was appointed to the subcommittee. Subsequent to his appointment and his investigative efforts came the exposure of the corruption and scandalous practices of the investment banker (private) and the commercial banker. In April of 1933 the scope of the inquiry widened to make a thorough and complete investigation of the operations and business practices of private bankers as well. Common practices uncovered by the investigation included the following: reputable investment houses that pushed on unsuspecting investors the securities of a company in which they were closely associated; speculation on the stock exchange; and evasion of income taxes on huge earnings by investment bankers. These questionable activities were aided by the commercial banks as they advised their depositors to use their affiliates' security salesmen for investment advice. The disclosure of these abuses through Senate hearings and the press shocked the public and paved the way for government regulation.

## IV

**1933 Creation of Glass-Steagall**

THE GRAY-PECORA INVESTIGATIONS' DISCLOSURE of unsavory practices such as tax evasion, stock speculation, and forced stock selling resulted in vehement public reaction. Given the disastrous condition of the financial system in the early 1930s, these disclosures were untimely, in that they perpetuated general distrust and shattered confidence in the system. Thus, as Carosso (1970) argues, the Glass-Steagall provisions were designed, in part, to restore public confidence in the banking system. As one scholar puts it: "the conspicuous abuses of the period 1927–1929 had made legislation of this [Glass-Steagall] sort politically necessary" (Anderson 1949:321). Thus, from a political standpoint, the Roosevelt administration was forced to implement changes in the investment banking field once the findings of the investigation became public knowledge.

*A. Provisions of the Glass-Steagall Act*

The term "Glass-Steagall Act" refers to those sections of the Banking Act of 1933 that deal specifically with investment activity within the commercial banking sector. Four sections of the Banking Act of 1933 were designed as a means of separating commercial from investment banking. Sections 16 and 20 prohibited national and state member banks from underwriting corporate equity and debt securities. National banks, state member banks, and their affiliates were prohibited from dealing in securities. However, for state, non-member banks, federal law constructed a legal wall between commercial and investment banking activities, prohibiting non-member banks from themselves engaging in certain securities activities, but not prohibiting their affiliation with securities activities (Symons and White 1984:433). Section 21 prohibited any financial institution engaged in deposit banking, including private banks, from underwriting securities, with several exceptions. These exceptions included U.S. government obligations, state or political subdivision obligations, or obligations issued under the authority of the Federal Farm Loan Act, the Federal Home Loan Banks, or the Home Owners' Loan Corporation (*Banking Act of 1933*, p. 185).

Finally, section 32 prohibited the officers of member banks from engaging in the purchase, sale, or negotiation of securities.<sup>2</sup>

### *B. Interest Group Positions*

The evidence discovered regarding the banking sector's position on the Glass-Steagall bill indicates a metamorphosis of opinion between the 1932 Gray-Pecora investigation and the months just preceding the passage of the 1933 Act. Specifically, both large and small commercial bankers as well as investment bankers were initially opposed to the separation of commercial and investment banking activity. However, by late spring of 1933 these bankers had a change of heart and supported the separation of commercial and investment banking.

#### *1. Early Opposition*

Commercial bankers' opposition stemmed from several perspectives. Many commercial institutions, both large and small, were operating through security affiliates, and doing so because it was profitable. Indeed, in 1932, 36 percent of national bank profits came from their investment affiliates (*Wall Street Journal* 1933b, p. 1). Thus, a loss of profit from securities activities was one motivation for commercial bank opposition.

A second motivation for opposing the Glass-Steagall bill rested on the ability of the commercial banks to provide necessary capital to the other sectors of the economy. The Federal Advisory Council of the Federal Reserve Board stated its opposition to the bill based primarily on its belief that such legislation would hinder the ability of financial institutions to provide long-term capital to the non-financial business sector (*Wall Street Journal* 1933a, p. 1). Bankers argued that without affiliates and without branch banking, they would be unable to supply adequate capital to their customers.

Commercial bank opposition also stemmed from the belief that the proposed reforms were too severe. Several national banks argued that the proposed separation of commercial and investment bank activity was too drastic and that rather than separation, supervision ensuring safe investments with deposits would be more desirable (*Wall Street Journal* 1933b, p. 1). According to *Bankers' Magazine*, bankers expressed their opposition based on the bill's drastic nature and the fact

that it placed too much faith on unwise legal restrictions (1932c, p. 493).<sup>3</sup>

The American Bankers Association stated their opposition to the Glass-Steagall bill in 1932, based on their belief that it was contrary to the stabilizing function of the Reconstruction Finance Corporation. Specifically, the American Bankers Association was fearful that the forced separation of commercial and investment banking would cause a further liquidation of securities, thereby decreasing their market value at a time when further losses would be disastrous (*Bankers' Magazine* 1932b, p. 410).

Other bankers were concerned that the bill, by banning commercial member banks from participating in any securities issue other than certain government obligations, would eliminate competition in corporate or public utility security fields (*Bankers' Magazine* 1933a, p. 253). By removing the commercial banking institutions from securities dealings, the only institutions left to compete in the underwriting and distributing of non-government securities would be investment banks and trust companies.

Private investment bankers were also opposed to the Glass-Steagall bill early in the debate, often citing similar arguments as the commercial bankers. A spokesperson for the Investment Bankers Association of America argued that the relationship between commercial banks and their security affiliates was necessary to provide adequate capital to the non-financial sectors (*Bankers' Magazine* 1931, p. 459). Thus, during 1932 and early 1933, both large and small commercial bankers and investment bankers were opposed to the Glass-Steagall bill.

## *2. Change of Heart*

Several developments facilitated the metamorphosis of opinion among interest groups. First, disclosures of senatorial hearings regarding First National Corporation were made public in March of 1933. No previous disclosures "so shattered the image and reputation of the investment banker as did the evidence of [First National Corporation's] financial chicanery and skullduggery" (Carosso 1970:325–326). The abuses uncovered appalled even the financial community and caused bankers to reconsider their earlier opposition.

Charles McCain, board chairman of the Chase National Bank, testi-

fied at the hearing after the National City Corporation disclosures and argued that strict regulations be placed on commercial and investment activity to protect depositors and discipline bankers (*Stock Exchange Practices: Hearings*, 73rd Cong., Pt. 8, p. 4194). Winthrop Aldrich, executive head at Chase National, declared in his testimony that investment and commercial banking should be separated completely, thereby casting a supporting vote for the Glass-Steagall bill.

A second development was the announcement by several large banks, led by Chase National in March 1933 and followed quickly by National City, that they were taking steps to divorce their security affiliates from their commercial institutions. Such action signaled to other financial institutions the acceptance, if not inevitability, of national law mandating such a divorce.

The third and final development was structural. Security affiliates were no longer a source of profit. Stock prices crashed in 1929; however, those with money rushed to purchase the devalued stock and by early 1930, the market had regained much lost ground. Amidst bank failures and wavering confidence, the market began its slide in April of 1930. Indeed, the average price of all listed shares fell from \$69.01 in January of 1930 to \$28.50 in April of 1932 (*Stock Exchange Practices: Hearings*, 72nd Congress, Pt. 1, p. 861). In addition, overall commercial bank profit fell drastically in 1931, and 1932 was the first time in the history of the national banking system in which all banks, collectively, posted a deficit (*Bankers Magazine*, 1933b, p. 422). With profitability falling, the banking industry became less resistant to and even supportive of the proposed Glass-Steagall bill. Ultimately, the Glass-Steagall Act was passed as a part of the Banking Act of 1933, paving the way for a new structure in both commercial and investment bank activity.

## V

### **Glass-Steagall Reform in the 1980s and 1990s**

CONTEMPORARY ATTEMPTS at reforming the Depression-era separation of investment and commercial banking were initially a response to market innovations in the 1970s. Specifically, the creation of money market mutual funds and the increasing use of commercial paper created important new sources of competition to the commercial banker. How-

ever, the banker was largely unable to respond to, or participate in, these market developments because of the Glass-Steagall provisions.

Money market mutual funds were first introduced in 1972 and experienced tremendous growth in the 1970s and 1980s. Banks were unable during this period to offer money market accounts although mutual fund companies were accepting deposits. Commercial paper issues also grew rapidly through the 1970s and 1980s. Indeed, this growth continues, as evidenced in Berger, Kashyap, and Scalise (1995), who indicate that between 1979 and 1994 commercial paper issues tripled in real dollar value while the percent of corporate bank lending declined. Banks were prohibited through Glass-Steagall from the commercial paper business in which the underwriting firm enjoyed fees, and in some instances a percentage of the interest, from the issuing firm. Though the Federal Reserve did rule that banks could participate in non-underwriting activities of the commercial paper market, most of the business was still prohibited under Glass-Steagall.

In addition to the growth of mutual funds and commercial paper, legislative reform attempts in the mid to late 1990s were also spurred by other market developments. Technological advancements in telecommunication and data processing lowered costs and barriers to information, thereby eroding banks' competitive advantage in lending. This opened the doors for both further domestic non-bank competition as well as foreign competition. The dynamic realities of the market were making it increasingly difficult for the commercial banker constrained by Glass-Steagall.

Another impetus for regulatory reform was the interest by Congress to make legislative reforms before the actions of the Federal Reserve and other bank regulators eroded the Glass-Steagall provisions without them. This desire was made explicitly clear in a 1988 Senate Committee on Banking, Housing, and Urban Affairs Report, which states, "it is the intent of the Committee to reassert Congressional influence over the pace and direction of change in our financial system" (*Financial Modernization Act of 1988*, March 22, 1988, p. 2).

Three different avenues exist for regulatory change within the banking industry. First, change may be the product of the regulators' decisions, such as the Federal Reserve or the Office of the Comptroller of the Currency. Second, the rulings of the courts may change legal parameters for industry behavior. Finally, Congress may legislate change.

In essence, it may be said that until November of 1999, change came about largely as a result of piecemeal decisions made by the courts and regulators, and not by legislative action on the part of Congress.<sup>4</sup> Indeed, it took over 10 years and countless legislative bills for Congress to finally weigh in on the Glass-Steagall issue. And by the time Congress did pass reform legislation, the courts and regulators had already dismantled many of the barriers to commercial and investment banking. Why did Congress have so much trouble acting when the courts and regulators did not? Where did the bankers, brokers, and insurance companies stand on the issue of repealing Glass-Steagall? The following contemporary analysis answers these questions.

#### *A. 1988 Legislative Reform Attempt*

Ultimately, the initial legislative attempt at repealing the Glass-Steagall provisions failed because the House and Energy and Commerce Committee were unable to compromise. The central issues throughout the 1988 debate were bank securities powers, insurance powers, and appropriate fire walls separating banks and securities affiliates.<sup>5</sup> Though the House and Senate bills largely were in agreement on these issues,<sup>6</sup> the Energy and Commerce Committee bill contained tighter restrictions on all of the central issues. Further, Energy and Commerce, which was responsible for securities regulation, was charged by the House with overstepping the Banking Committee's jurisdiction over banks' securities activities. This power struggle, coupled with the end of the congressional session, led to the demise of the 1988 Glass-Steagall reform efforts.

In terms of different interest group positions, large commercial bankers were in favor of expanded bank powers in the area of securities investments. This support stemmed from their desire to have more equal opportunities to compete with non-banks and banks both domestically and abroad and to adjust to the dynamic changes within the financial services sector. The large bank position is summed up well in a statement made by Roberto G. Mendoza, Executive Vice President of Morgan Guaranty Company:

[W]e cannot be complacent about the competitive position of our financial markets. We believe that one of the primary reasons, but not the only one,

for these unfortunate developments is the anticompetitive effects of the Glass-Steagall Act. Not only does the Glass-Steagall Act preclude full and open competition among financial services firms in the United States, but it also significantly constrains their ability to compete in capital markets. (U.S. Congress 1987, p. 42)

Small banks, in contrast, were largely opposed to any Glass-Steagall reform, fearing it would lead to large banking conglomerates that would run them out of business. The Independent Bankers Association of America opposed the various versions of the reform bill on the grounds that they would concentrate power in the hands of a few large banks and securities firms (*Congressional Quarterly Almanac* 1988, p. 232).

Like the large commercial banks, large securities firms were in favor of regulatory change. The securities firms were interested in expanding into commercial banking, just as the bankers were eager to expand into the securities business. Many argued that the weakened state of the commercial banking sector was a reflection of the limitations placed on banks by the Glass-Steagall provisions. Further, the poorly performing commercial banking sector was seen as evidence that the entire financial system in the United States was faltering. From this perspective, reform was needed to aid the entire industry, not just commercial banks.

Insurance firms were opposed to any increases in insurance powers for commercial banks, as this was seen as an expansion and increase in competition. However, once the bill's provisions were changed so that bank holding companies could sell insurance only in the home state of the holding company, provided the state allowed this, insurance lobbyists praised the bill.

Ultimately, the only powerful interest group opposed to the repeal of Glass-Steagall in 1988 was the Independent Bankers Association, representing the small banker. Yet, despite the overwhelming support for legislative change, the bill died due to power struggles between legislative committees.

#### *B. 1991 Legislative Reform Attempt*

By 1991, serious problems beset the financial sector. Thousands of savings and loans had failed in recent years, and hundreds of com-

mercial banks were failing annually. In turn, the Bank Insurance Fund was in dire need of recapitalization. At the same time, given the turmoil on Wall Street, performance was weak in the securities industry. In response, the Bush administration produced a broad plan for restructuring the financial sector, which included expanding bank powers into the securities and insurance markets. After much debate and compromise, Congress did pass a banking bill, though the contents were much narrower than the administration's initial plans. Further, repeal or partial repeal of Glass-Steagall did not survive and, like 1988, this was largely the result of the House Energy and Commerce Committee, which derailed the repeal efforts. After this failure, reforming the Depression-era legislation would have to wait another four years for further consideration.

Whereas in 1988, much of the debate focused on restoring bank competitiveness within the financial sector, the debate three years later was on restoring safety and soundness. In general, large banks and some members of the securities industry supported Glass-Steagall repeal on the grounds that it would strengthen the financial industry by increasing opportunities for profit. Small banks, others from the securities industry, insurance agents, and consumer groups opposed the repeal, arguing that it would actually weaken the industry by creating a few large conglomerates.

Concern regarding the undercapitalized Bank Insurance Fund made other banking reform issues more pressing. Consequently, there was little urgency behind the Glass-Steagall reform efforts. Coupled with the opposition from the House Energy and Commerce Committee, this lack of commitment made reform all the more difficult. Thus, this second legislative effort at dismantling the separation of commercial and investment banking also failed.

### *C. 1995 Legislative Reform Attempt*

Whereas the backdrop to the 1991 debate was crisis in much of the financial sector, the 1995 debate occurred while regulators and courts continued to push reform on their own. More specifically, the Comptroller of the Currency, Eugene A. Ludwig, ruled that national banks in small towns were permitted to sell insurance. Though in 1995 this rul-

ing was challenged and under review at the Supreme Court, it was a clear sign of the regulator's intent. Further, the Federal Reserve announced it would increase the amount of bank holding company business that could be generated through securities affiliates. Taken together this produced pressure on legislators to respond to evolutions in the market, particularly as they related to Glass-Steagall.

The legislative reform effort, largely championed by Jim Leach, R-Iowa, failed again in 1995 as the reform proposals were ultimately unacceptable to both the banking and insurance interest groups. Leach's bill had initial overwhelming support from the commercial banking and thrift sectors but was fought by insurance agents, despite the fact that the original bill was extremely focused on the bank and securities industry and in no way tried to alter the insurance and banking relationships. In a concessionary move to the insurance agents, the House added a requirement to create barriers to further national bank entry into the insurance business. This concession was deemed too egregious by commercial bankers who then insisted the bill be set aside.

Banks were also willing to set aside this bill because of an anticipated Supreme Court ruling. Specifically, the Court was expected to rule in the spring of 1996 in the case of *Barnett Bank v. Nelson*; if the ruling favored the bank, it would clear the way for banks in towns of 5,000 or fewer to sell insurance. Rather than accept immediate concessions, bankers decided to wait out the Supreme Court ruling in hopes that it would expand some commercial banks into the insurance business.

Prior to discussions that would place a moratorium on commercial bank expansion into the insurance industry, large commercial bankers were in favor of repealing the Glass-Steagall provisions for much the same reason as previous reform attempts. Support turned to opposition, however, once the moratorium was introduced in an attempt to placate the insurance agents. Small bankers, much like previous reform attempts, were still opposed to the idea of marrying commercial and investment banking. They continued to be fearful that the outcome of such a marriage would be industry consolidation and the elimination of the small bank, and hence the dual banking system.

The position of the securities industry, again much as in 1991, was mixed, as some considered the reform a welcome opportunity for ex-

pansion and increased profit while others feared unfair competition from banks because of deposit insurance. Insurance agents also felt that allowing commercial banks to sell insurance would give the banker an unfair advantage because of deposit insurance and other potential product tie-ins.

Though many of the interest group representatives in favor of repeal indicated that the time for Glass-Steagall reform was urgent, legislators did not possess that same feeling of urgency. Toward the end of the year, legislators, particularly in the Senate, became preoccupied with the Whitewater investigation and Glass-Steagall reform was essentially pushed aside. In addition, by this time the bankers opposed the reform bill, so that with little interest group support and little legislative priority this third serious attempt at the repeal of Glass-Steagall failed.

#### *D. 1996 Legislative Reform Attempt*

The fourth serious attempt at legislative Glass-Steagall repeal took place in 1996. This effort was primarily the result of Representative Leach's strong desire to expand banking activities and his relentless efforts to drum up support for the repeal. However, much like in 1995, this reform effort failed, as interest groups and legislators were largely indifferent to it.

Legislators were extremely reluctant to move forward on Glass-Steagall repeal prior to the Supreme Court ruling on the *Barnett* case. Banks had also adopted this wait-and-see attitude. On March 26 the Supreme Court upheld the Comptroller's ruling to allow national banks to sell insurance in small towns. This ruling was a victory for the commercial banker who, not surprisingly, was opposed to any further legislative attempts at curbing bank insurance activity. At the same time, the insurance companies and insurance agents would not support any reform that did not put a halt to further bank expansion into the insurance field. This dispute meant that the very industry the reform was aimed at helping, commercial banks, opposed the various bills, as they threatened the insurance victory earned in the *Barnett* ruling.

Even after *Barnett*, legislators were not willing to bring the Leach bill to the floor of the House for political reasons. Though it was widely accepted that Glass-Steagall reform was desirable, the fact that

the commercial banks and the insurance industry were at such odds meant that a vote would, in all likelihood, alienate a powerful industry group. This reluctance was compounded by extreme indifference from Senate Banking Committee Chairman Alfonse M. D'Amato. The Senate Chairman indicated that he would not move forward until a House vote occurred, and most House leaders were not optimistic about that happening.

Since legislative action failed during the year, the Federal Reserve took action by liberalizing banks' securities activities. Beginning in 1988, the Federal Reserve allowed bank holding companies to underwrite and sell securities through affiliates, provided these activities generated no more than 10 percent of the affiliates' revenue. In December of 1996, this limit was raised to 25 percent of total revenue. In addition, the Comptroller of the Currency issued regulation to allow subsidiaries of national banks to engage in many non-bank activities, potentially including securities and insurance underwriting and distribution. Thus, after four legislative reform attempts, the only reform came piecemeal from regulators and courts.

#### *E. 1997 Legislative Reform Attempt*

The 1996 regulation changes announced by the Federal Reserve and the Comptroller greatly altered the landscape for the 1997 debate. More specifically, the announcements gave greater freedoms to the commercial banker who, in turn, became increasingly reluctant to support any legislative that would threaten these freedoms. In other words, since the regulatory concessions, absent during earlier reform debates, were seen as something to protect, the commercial banker was more deliberate when aligning for or against a bill. The 1997 debate also differed from previous reform attempts in that the debate during this year centered on whether commercial bank activity and commerce activity should be mixed. Though this had been discussed previously, it became a central issue in 1997.

While the 1997 debate was unique from some perspectives, it was, at the same time, extremely reminiscent of earlier reform attempts, particularly the 1996 attempt. As in 1996, this attempt at repealing Glass-Steagall was met with a lukewarm reception from the interest groups

within the financial sector as well as from the legislators themselves. Commercial bankers were concerned with increasing their securities and insurance activities, but not at the expense of losing freedoms granted at the end of 1996. Securities firms were largely in favor of expanding into commercial banking and insurance, though some continued to argue that deposit insurance and the federal regulation scheme in banking gave bankers a competitive advantage. The insurance industry was still at odds with the commercial banking sector, fearing that the banks would have a competitive and regulatory edge if allowed to sell insurance. Finally, small bankers continued to be fearful that the repeal and possible integration of banking with commerce would create conglomerates that would hurt the consumer and small banker. Thus, the positions of the interest groups were much as they had been in 1996.

Another similarity to 1996 was the reluctance of legislators to enthusiastically support the reform proposals. Senate Banking Committee Chairman D'Amato continued his passive indifference to the reform and the previously energetic Representative Leach was discouraged and frustrated by the middle of 1997. Further, the friction between interest groups again made legislators unwilling to align themselves against one particular group by voting on a reform bill. Consequently, as with previous reform efforts, 1997 did not produce legal reform of Glass-Steagall.

#### *F. 1998 Legislative Reform Attempt*

Reform efforts in 1998 began much as they had previously. Commercial bankers were never much in favor of this reform bill because it would have required banks, securities firms, and insurance companies to all be regulated in the same way and under the same regulators. Commercial banks felt this would be a step backward for them, as they had a good relationship with their current regulators, the Federal Reserve Board and the Comptroller of the Currency. Further, some commercial bankers opposed the reform bill because it would place 1977 Community Reinvestment Act (CRA) provisions on the new financial conglomerates. Ultimately, the reluctance of the banker to back any reform bill meant that the legislators, particularly in the Sen-

ate, were again unwilling to bring any bill up for vote for fear of alienating important industry groups and losing their generous financial contributions.<sup>7</sup>

The real spark in this reform attempt came from the market after the House had pulled its bill from the floor due to lack of support. On April 6, 1998 Citicorp and Travelers proposed a merger that would have created the largest financial institution in the world. At the same time, this proposed merger would create a conglomerate engaged in banking, securities, and insurance clearly not allowed under Glass-Steagall provisions. Consequently, if the merger was approved and Glass-Steagall not repealed, it meant that the new firm would need to divest certain insurance and securities activities. Many hoped that this market development would add some urgency to the legislative reform attempt.

The Travelers and Citicorp merger did signal to the legislators that the market was moving ahead with or without them. Not wanting to be left behind, the House narrowly passed a reform bill the following month and the Senate Banking, Housing and Urban Affairs Committee approved the same bill in September. Optimism regarding legislative reform was killed, however, in the Senate as Phil Gramm, R-Texas, vehemently opposed the CRA provisions contained in the bill, specifically, the requirement that the financial conglomerates being created through the legislative process earn passing grades in their community lending performance. There was little incentive for other Senators to pressure Gramm, as it was well known that President Clinton intended to veto the bill since Treasury Secretary Robert Rubin opposed it on the grounds that it gave regulatory power over the financial conglomerates to the Federal Reserve and not the Treasury. Thus 1998 ended without legislative reform despite market developments indicating that not only was Glass-Steagall clearly obsolete but also that market participants were able to successfully avoid restrictions in order to remain competitive.

#### *G. 1999 Legislative Reform*

In the final year of the millennium Congress again debated reforming the Depression-era separation of commercial and investment banking.

However, in contrast to the previous attempts, this ending would be different; legislative change would finally prevail.

This attempt at reform began under new leadership in Congress. Phil Gramm, R-Texas, became the Chair of the Senate Banking, Housing and Urban Affairs Committee while Jim Leach, R-Iowa, chaired the House Banking and Financial Services Committee. Both gave financial reform high priority. By May both the House and the Senate had passed reform bills that would repeal Glass-Steagall. Though the bills were supported by large banks and securities firms, small bankers continued to be concerned that they would be unable to compete with the financial conglomerates, and insurance companies were concerned about provisions that expanded state regulatory authority of insurance products.

Passage of legislative reform was still not certain, however, because the House and Senate bills differed on three key issues. First, the House bill retained CRA provisions requiring banks to lend to poor community members, while the Senate bill exempted small rural banks from the CRA. Second, as in 1998, the two bills differed in terms of who should regulate the proposed financial conglomerates. A third point of disagreement was over privacy issues. More specifically, the House bill contained several privacy measures, including giving consumers the ability to "opt out" of information sharing with third parties. The Senate bill contained no such provisions. Debate over these issues ran well into the fall and, at several points, it appeared as though the bills would die due to these disagreements.

Eager for legislative reform, it was the lobbyists for the financial industry interest groups who stepped in to keep the discussions moving forward, ultimately culminating in the passage of Glass-Steagall reform. Indeed, Daniel J. Parks, writing for *CQ Weekly*, summarized the interest group role:

The Industry's efforts to jump-start progress on the [Senate] bill is a case study in how a well-heeled and well-organized interest group can swiftly prod Congress to move, even on an issue about which most people outside Washington and New York have little knowledge. (1999:2373).

As in previous years, these lobbying efforts included millions in PAC contributions. In the first half of 1999 alone, banks, brokers, and insurers gave at least \$6.6 million to congressional candidates, includ-

ing \$1.2 million to the House Banking Committee and \$480,000 to the Senate Banking Committee (Parks 1999:2373–2375). The American Bankers Association, the Independent Community Bankers of America, the American Council of Life Insurance, and the Securities Industry Association, to name a few, all stood in favor of passing legislative reform and all pressured Congress to come to a consensus over the issues. The interest group pressure was successful as in mid November President Clinton signed the financial services overhaul bill that repealed Glass-Steagall.

## VI

### **Analysis of Glass-Steagall Reform**

HAVING ESTABLISHED the interest group positions and market developments in the early 1930s and then again in the late 1990s we are now in a position to give further consideration to the nature of this process and to consider the implications for future policy and market participant behavior.

Comparing interest group positions in 1933 and in the 1990s it is clear that, in each case, the groups acted “rationally,” which, to the economist, means in their own self-interest. During the Great Depression, large and small commercial bankers and investment brokers opposed Glass-Steagall because it would harm them either through increased competition or lost revenue. Only when it became apparent that the separation of commercial and investment banking was inevitable did the interest groups lessen their opposition. Recall, also, that profits from securities activity were severely curtailed during this time, so incentive to fight the separation was minimized. In the contemporary reform debate it is equally clear that the interest groups continued to struggle for a competitive and profitable position within the financial sector. For example, small bankers were never fully behind the repeal of Glass-Steagall for fear that they would be unable to compete with the large financial supermarkets predicted to emerge with the reform. The finding that the interest groups acted to protect their self-interest is not surprising.<sup>8</sup>

Nor is it surprising, according to both political science and economic literature, that the interest groups played a vital role in the

timing of the 1999 deregulation. Without persistent lobbying by commercial and investment interests it is unlikely that reform would have taken place in this century. Despite the important role of the interest groups, one must be careful not to overlook an equally important role played out in the financial markets themselves. As is well documented, financial markets were moving beyond the Glass-Steagall restrictions despite the lack of legislative consent. Beginning in 1986 regulators began expanding the scope of permissible banking activity because Glass-Steagall had become too restrictive, given market dynamics. The 1998 merger between Citicorp and Travelers was simply the last and largest market development that served as evidence of market participants essentially ignoring Glass-Steagall. These market developments certainly weighed on the minds of legislators and engendered a sense of urgency regarding reform.

Similarly, it is clear that in the 1930s passage of the Glass-Steagall bill, provisions may very well not have occurred had it not been for private market developments. Recall that opposition to the separation of commercial and investment banking was reduced once the stock market began performing poorly. Since investment banking was no longer very profitable, commercial bankers no longer possessed the incentive to fight Glass-Steagall. Thus, even in the 1930s, market developments played an important role in this banking policy.

From this perspective, neither the iron triangle nor the issues network literature fully explain the Glass-Steagall policy change because neither give non-political forces, such as markets, an important place theoretically. Nonetheless, Heclo's (1978) vision does seem more consistent with the Glass-Steagall case as he allows for change within the political access structure as government itself changes. He argues that the very creation of policy and regulation creates different interests and thereby breeds more interested groups: "policies greatly increase the incentives for groups to form around the differential effects of these policies" (1978:96). The flexibility Helco envisions is similar to the flexibility afforded to non-regulated market participants to adjust to changing competition, products, and opportunities.

What lessons can be drawn from this case study of Glass-Steagall reform? Perhaps one obvious lesson is that if policy is such that the firm is hurt from a competitive or profit perspective the firm will act to avoid

the policy or regulation. It may be useful, then, to think of different interest groups as rival entrepreneurs where regulatory avoidance is an entrepreneurial activity. If policy is such that the firm is constrained from the market, the rival entrepreneurs respond by avoiding regulation or adapting to market dynamics differently than had they not been regulated. This leads to a second, perhaps not so obvious, lesson, which is that since regulation necessarily changes the course of the market, it can never be considered harmless. Even if deregulation occurs, the once-regulated market will not return to "the way things were" because the previous regulation and the regulatory avoidance has altered the path of the market in ways that an unregulated market never would have. One may argue that a regulated market may produce new opportunities. However, as Kirzner (1991) points out, not all these opportunities may be desirable. For instance, one new opportunity created by regulation is the chance to bribe regulators. Finally, a third lesson that stems from this analysis must be that greater emphasis should be placed on the role that market developments play in influencing the political process, particularly changes in regulation. Existing literature in both economics and political science fail to provide an appropriate role for markets in the process of regulatory change.

## VII

### **Looking Ahead**

WILL FURTHER REFORM BE LIKELY? Yes, because bankers continue to be constrained by regulation. One such regulation brought to light in the contemporary Glass-Steagall debate is the CRA provisions requiring banks to make loans to their community with little regard to ability to repay. Bankers have responded by closing branches in poorer communities to avoid these requirements. Pawnshops and check-cashing institutions have sprung up in their place, charging outrageous annualized interest rates; 500 percent is not unusual. Bankers are merely acting rationally and will continue to avoid policies that hinder their competitive position or profitability. Interest groups, acting as rival entrepreneurs, will continue to try to free themselves from the constraints of regulation, particularly as these constraints reveal themselves through market developments.

Table 1  
Key Contemporary Regulatory and Court Decisions  
Affecting Banking

Year	Ruling
1986	The Office of the Comptroller of the Currency declares national banks eligible to sell insurance nationwide.
1987	The Federal Reserve Board authorizes subsidiaries of bank holding companies to earn up to 5 percent of their revenue from underwriting and distributing certain securities.
1989	The Federal Reserve Board authorizes subsidiaries to earn up to 10 percent of their revenue from underwriting and distributing certain securities.
1991	The Federal Reserve Board authorizes foreign banks to underwrite securities through a subsidiary instead of through the subsidiary of a holding company.
1993	A Circuit Court judge rules that national banks can sell insurance in towns with 5,000 or fewer residents.
1995	The Supreme Court rules that annuities are a banking product that may be sold by banks.
1996	The Supreme Court rules that national banks can sell insurance in towns of 5,000 or fewer residents even if state law prohibits.
1996	The Federal Reserve Board authorizes subsidiaries to earn up to 25 percent of their revenue from underwriting and distributing certain securities. The Comptroller of the Currency authorizes subsidiaries of national banks to engage in non-bank activities.

*Source:* Hosansky 1997:2295.

Table 2

Key Provisions of Legislative Glass-Steagall Reform Attempts

Year	Key Provisions
1988	<p>New Bank Powers</p> <ul style="list-style-type: none"> <li>—would permit member banks to affiliate through bank holding companies with securities firms.</li> <li>—would permit banks to underwrite and distribute state and local bonds backed by non-tax revenue.</li> <li>—would authorize national and state charter banks to underwrite and sell investment trusts and to sell shares in a mutual fund not operated by the bank.</li> <li>—would permit bank affiliates to sell and underwrite all securities, with mutual funds and corporate securities activity beginning 180 days after passage.</li> <li>—would not permit banks with deposit insurance to have direct securities subsidiaries or affiliates.</li> <li>—would permit securities affiliates to engage in banking activity to the extent allowed by the Bank Holding Company Act.</li> <li>—would require securities affiliates to issue written notices alerting consumers that they are separate from the related bank and not federally insured.</li> </ul>
1991	<p>New Bank Powers</p> <ul style="list-style-type: none"> <li>—would effectively remove Glass-Steagall, though the Senate bill does not allow for mergers between large banks and large securities firms.</li> <li>—would roll back regulatory interpretation of insurance activity.</li> <li>—would not permit banks to finance the purchase of securities underwritten by an affiliated securities firm.</li> </ul>
1995	<p>New Bank Powers</p> <ul style="list-style-type: none"> <li>—would create financial services holding (FSH) companies, in place of bank holding companies, allowing the companies to control both securities affiliates and commercial banks.</li> <li>—would permit the FSH to offer mutual funds, investment advice, corporate underwriting, and other securities services.</li> <li>—would create investment bank holding companies, which are bank holding companies with a wider range of securities activities.</li> </ul>

Table 2  
*Continued*

Year	Key Provisions
1996	Largely the same as 1995.
1997	New Bank Powers <ul style="list-style-type: none"><li>—the Treasury plan would permit commercial banks to participate in both securities and insurance activities either through a subsidiary or through an affiliate.</li><li>—the Treasury plan would allow one of the two following options:<ol style="list-style-type: none"><li>1. A limited portion of the bank holding company revenue could be generated through non-financial business.</li><li>2. Non-financial business of the bank holding company could be generated only through thrift affiliates with unique powers.</li></ol></li><li>—would permit state insurance authorities to regulate bank insurance activities.</li></ul>
1998	New Bank Powers <ul style="list-style-type: none"><li>—would create financial holding companies (FHC) that remove all restrictions between bank, securities, and insurance firms. Banks can acquire securities and insurance firms.</li><li>—would permit FHCs to acquire a limited number of commercial interests with certain provisions.</li><li>—would eliminate unitary thrift charters.</li></ul>
1999	New Bank Powers <ul style="list-style-type: none"><li>—creates financial conglomerates that remove all restrictions between bank, securities, and insurance firms. Banks can acquire securities and insurance firms but the securities and insurance activities will be regulated by their respective state and federal regulators.</li><li>—creates wholesale financial institutions (WFI) whose deposits are not covered by FDIC. The WFI is not affiliated with insured commercial banks and not subject to CRA provisions.</li><li>—thrifts can no longer be affiliated with commercial enterprises.</li></ul>

Sources: *Congressional Quarterly Almanac* 1988, 1991, 1995, 1996. *Congressional Quarterly* 1997, 1998, 1999.

Finally, since the market continues to evolve, it will always produce new niches, new opportunities for profit, new competitors, and so forth that cannot be foreseen by market participants or policymakers. Thus, rival entrepreneurs will continue to lobby for legislative reform; both for more and for less regulation. An ever-evolving market also means that economic equilibrium is not possible. Consider the life of Glass-Steagall. Some may argue that between 1933 and 1999 there was equilibrium because commercial and investment banking was separated by law. However, as this case study reveals, market participants continued their struggle to push regulatory boundaries and to adapt to change. From this perspective, it is not useful to analyze regulation and legislation from an optimizing standpoint with an equilibrium outcome. Rather, when the 1933 Act separated commercial and investment banking, there was no equilibrium, but a new set of rules for the commercial and investment banker to do business by. Some entrepreneurial groups may have lost the battle while others won, but over the course of time market dynamics cause rival entrepreneurs to continue to seek profitable opportunities, which often lie outside the constraints of regulation.

### Notes

1. According to Becker, "political equilibrium has the property that all groups maximize their incomes by spending their optimal amount on political pressure, given the productivity of their expenditures, and the behavior of other groups" (1983:372).

2. While these provisions divorced commercial and investment banking activities, the divorce was not complete. The exceptions to sections 16, 20, and 21 outlined above indicate one point of incomplete separation. In addition, the Act did not prohibit commercial banks from merely executing securities orders on behalf of customers without giving them investment advice (Litan 1987:28; Eccles 1982:92). Finally, the Act's separation requirements did not apply to foreign markets as American banks were allowed to underwrite corporate securities abroad. Hence, not all avenues for investment dealings were closed to commercial institutions by the Banking Act of 1933.

3. This same point is made in an earlier article, "Editorial Comment: The Glass Bill" (*Bankers' Magazine* 1932a, p. 261).

4. See Table 1, which contains a brief summary of the key contemporary regulation and court decisions that slowly eroded Glass-Steagall.

5. See Table 2, which contains a brief summary of the provisions contained in each reform effort.

6. The House and Senate bills, though similar on these central issues, parted ways over consumer protection issues. Specifically, the initial House bill stiffened the Community Reinvestment Act requirements before banks could enjoy greater securities activities.

7. As evidence of the financial implications of upsetting a particular interest group, consider that in 1997 banks, securities firms, and insurers provided almost 20 percent of the total unlimited soft-money donations from private enterprises. Further, financial services political action committees (PACs) have given \$10 million in the 1998 election cycle, which is almost double the giving of the second industry PAC (Gleckman and Foust 1998:38).

8. It is also consistent with Stigler's (1971) theory of economic regulation, which says that an industry may seek regulation or deregulation that, for a number of reasons, may be beneficial to it.

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